Strategic Insight

IMF Stabilization Programs and the War on Terrorism: Conflicting or Complementary Objectives in Pakistan?

by Robert Looney

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Introduction

Because it is one of the front-line states in the war on terrorism, Pakistan's economy and economic management will be tested to the limit. Not only will the country have to likely allocate an increasing amount of resources to defense and security, it will also have to generate rates of growth sufficient to begin lifting large segments of the population out of dire poverty, a potential breeding ground for terrorism. A related weighty task is the development of strong governance institutions capable of facilitating the country's transition out of poverty (Bremer and Kasarda, 2002).

The reforms introduced by the Musharraf administration after seizing power in October 1999 are clearly designed to address many these problems, including the country's massive poverty, stagnant economic growth, deteriorating institutional framework and weak governance structures. A day before being sworn in for a new five-year presidential term that he arranged under a much criticized referendum, General Musharraf noted that the next five years were very important for Pakistan and hoped that the new government would take advantage of the "sound macro-economic policies" framed by his regime. "If Pakistan follows the course and implements the strategy that has been crafted after much deliberations and with great care, dividends would soon be there for us to reap," he stated, further adding that his administration had "pulled a rudderless ship out of the storm" and "set it on full sail" (*Dawn*, November 17, 2002). In this regard, he noted that he and his colleagues took pride in the fact that after more than two decades of stagnation, they had "brought the country to a take-off stage" and it was now time for the elected government to "build on the bricks laid by his team." Finally, he explained that he had taken certain difficult decisions in the larger and long-term interest of the country, and particularly, in the interest of its economic and political stability.

Although Musharraf did not mention it directly, the International Monetary Fund (IMF) has been instrumental in designing and assisting in the financing of the current modernization process now taking place in Pakistan. However, IMF successes in Pakistan have been extremely rare. The country entered into nine different agreements with the Fund during the period 1988-2000. None of these programs were fully implemented, largely because of the uncertainties and discontinuity caused by frequent changes in government. In fact, one of the reasons commonly cited for dismissal of several directly elected governments (including Bhutto and Sharif) was economic mismanagement. These developments caused the 1990s to be labeled a "lost decade" for Pakistan's economy. As a basis of comparison, during the four decades preceding the 1990s the annual average growth rate was almost 5% and the incidence of poverty had declined from 40% to 18%. However, the 1990s saw growth in per capita income dropping to slightly over 1%. Poverty resurfaced and about one third of the population now lives below the poverty line of $1 per day. Social indicators are much worse than other countries with comparable income. The country has turned from a moderately indebted to a heavily indebted country nearly helplessly caught in a debt trap. Before the military coup in October of 1999 the country was also perceived as deeply corrupt.

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As a starting point for assessing the potential effectiveness of the current IMF program it is instructive to look more closely at the 1990s experience. In particular:

1. Could proper economic management of the economy under the guidance and support of the IMF have avoided the economic disaster of the 1990s?
2. Would satisfactory economic performance have been possible without sharply reduced levels of defense expenditures?

These questions are particularly relevant today as the country tries to revive its economy with the IMF's close guidance and financial support. Has the Musharraf/IMF team been able to turn the economy around as Musharraf contends? Have the successes been achieved in conjunction with meeting pressing security needs brought on by the war on terrorism? At issue is whether or not, given the country's severe resource constraints, it is possible to construct a stabilization plan along IMF lines capable of achieving satisfactory rates of growth and poverty reduction, while leaving sufficient resources to shore up defenses for the war on terrorism.

Defense Expenditures and Growth in the 1990s

Pakistan's economic growth rates slowed from almost 7% in the 1960s to about 3% in the late 1990s and early 2000s. In the regional context, Pakistan grew faster than South Asia by an average of 2% through most of the 1960s and 1970s and at similar rates during the 1980s. However, since 1993 Pakistan growth has been well below the regional average. More generally, trends in growth in Pakistan had been steadily slowing from initially very high levels since the 1960s, whereas growth in South Asia has been steadily accelerating during the four decades.

In the early 1990s policy-oriented macroeconomic simulations of the economy (Looney, 1995) suggested that the fiscal pattern that had developed in Pakistan during the 1980s and into the early 1990s was not sustainable. Over-expansion in expenditures, both for defense and non-defense purposes, together with sluggish revenues and excessive foreign borrowing had created a situation in which growth would be increasingly constrained by debt servicing, inflation and shortages of domestic savings for private investors.

However, given the complex nature of defense expenditures in both stimulating (demand linkages) and suppressing (pre-empting resources) budgetary reductions in and of themselves were unlikely to improve the situation. On the other hand, modest efforts in tax reform were by far the most effective means for restoring fiscal stability. Based on these patterns, the optimal strategy for the '90s was one of tax reform together with an expansion of defense expenditures that was constrained in the 2.5% range. Unforeseen events aside, this package would enable the country to meet the goals established by itself and its major creditors in restoring a rapid self-sustaining growth in an environment characterized by a declining defense burden (defense as a share of Gross Domestic Product).

In short, macroeconomic simulations suggested that the country had through fiscal reforms the potential of sustaining a relatively high rate of economic expansion (around 5% in real terms) through the 1990s. Combining the fiscal simulations with an (admittedly subjective) estimate of their likely occurrence, the country was deemed to have a probability of around 40% achieving this favorable scenario—the bottom scenario in Figure 1: Pakistan's Fiscal Options in Year 2000. As things turned out, the country was not able to maintain fiscal discipline, the IMF suspended lending, and the top scenario of Figure 1 characterized by political instability, chronic fiscal crisis and stagnant economic growth was the path actually followed.

However, even if Pakistan had been able to implement fiscal reforms it is unlikely that the stable growth path noted above would have led by the end of the 1990s to a point where the country was ready to evolve into a dynamic South Asian Tiger (Looney, 2001). In this regard, the present Southeast Asian Tigers have a number of characteristics that set them firmly apart from Pakistan: (1) more rapid output

and productivity growth in agriculture; (2) higher rates of growth in manufactured exports; (3) earlier and steeper declines in fertility; (4) higher growth rates of physical capital supported by higher rates of domestic savings; (5) higher initial levels of human capital; and (6) higher rates of total factor productivity growth.

At the start of the 1990s, Pakistan simply lacked the foundation to approximate one of the East Asian Tigers: (1) the country's savings rate was one of the lowest in the world; (2) export performance had always been erratic; (2) manufacturing had not shown an ability to grow at a faster rate than the overall economy; (4) government consumptions accounted for a relatively high share of GDP; (5) the country's population growth remained relatively high; (6) as opposed to the Southeast Asian countries, Pakistan would be beginning its growth path with an extremely high debt ratio; and (7) by most measures, Pakistan's military expenditures were considerably above those in South-East Asia.

Most importantly, the country had seriously neglected the development of human capital. The country's literacy rate of 38% was one of the lowest in the world. Educational facilities were unevenly distributed and generally favored urban areas. Mortality and life expectancy indicators were similarly disappointing for a country of Pakistan's economic standing. Taking these factors into account a probability of only 8% was assigned to the prospect of Pakistan transforming into a dynamic East-Asian country by the year 2000 (Figure 1).

The Musharraf Reforms

After taking power in October of 1999, one of the first actions of the Musharraf government was to lay out an economic recovery plan. The strategy envisaged four key goals:

1. Macroeconomic stability and the restoration of a working relationship with international financial institutions (mainly the IMF, World Bank and the Asian Development Bank).
2. Structural reforms to remove distortions in the economy.
3. Improving governance, especially economic, and reviving key national institutions.
4. Poverty alleviation measures.

The implicit priorities underlying this approach are straightforward: good governance, economic revival based on strong fundamentals and freedom from debt and social harmony are interdependent goals. The overriding philosophy of the Musharraf government is that distortions in the economy are great inhibitors in achieving these objectives and thus have to be removed. The government's economic team and the IMF and World Bank staff shared Musharraf's diagnosis of the problems confronting the economy and the prescriptions required to fix them.

In sum, the Musharraf reforms need to be seen as a process unfolding over time. The first phase is to restore growth through macroeconomic stability and market reforms focused on increased total factor productivity and globalization. The second stage is to develop a governance structure capable of sustaining growth over a longer time frame.

IMF Medicine

IMF involvement in these reforms was not immediate. The relationship between Pakistan and the IMF in the early days of the Musharraf regime was strained. The IMF and its major contributors did not take the dismissal of a democratically elected government and the takeover by a military leader lightly. In addition, the new government had to inform the Fund about Pakistan's misreporting of the official deficit data for FY1998-99. As a result of these factors and the failed programs of the 1990s, the government lacked credibility with the Fund. The failed programs in the 1990s only compounded the Fund's suspicion that the country was incapable of delivering on its commitments.

Finally, around a year after the military coup that brought President Musharraf to power in Pakistan, the Executive Board of the IMF approved a Stand-by-Credit of U.S. $596 million. The program was to run

until the end of September 2001, supporting the Government's economic program for 2000-01. The program aimed to move Pakistan on to a high and sustainable growth path by strengthening its balance of payments position, rebuilding official reserves, and reducing public sector indebtedness. To support these objectives, the Government has strengthened macroeconomic policies and as noted above, developed a wide-ranging structural reform agenda that emphasizes revenue mobilization, improving investor confidence, poverty alleviation, and good governance. The IMF credit was subject to the following requirements:

1. A reduction in the overall budget deficit in 2000-01 to 5.2% of GDP from 6.4% in 1999-2000, with further consolidation over the medium term. This was to be achieved through increased tax collections, with a widening of the tax base, improved tax administration and strict expenditure controls. Since there is sufficient uncertainty surrounding the short-term impact of revenue measures on the budgetary position, the authorities should stand ready to take additional measures if revenues fall short of expectations.
2. Increased spending by close to one-third on poverty reduction and decrease in less productive spending.
3. An increase in gross official reserves from U.S. $1.114 billion (at the start of the program) to U.S. $1.74 billion at the end of June 2001, equivalent to 7.3 weeks of imports of goods and services, to be achieved through a flexible exchange rate policy, monetary tightening, fiscal adjustment, substantial exceptional financing, increased exports and sharply reduced private sector capital outflows brought about by a restoration of investor confidence.
4. Adequate expenditure control mechanisms would be put in place to ensure that the defense budget remains within the agreed limit and does not exceed the allocations as had happened in 1999-2000, when it increased by R $7 billion beyond the approved allocation.

The IMF terms were quite strict, but the country, after the many failures of the 1990s was in a very poor bargaining position. The country was on the verge of a serious financial collapse and the new government had assumed power with a commitment to avert this crisis.

The SBA was fully implemented without any problems. The country's improved standing with the IMF enabled the government to qualify for another IMF program, a three year Poverty Reduction and Growth Facility (PRGF) approved in 2001 that is well underway.

Performance Assessment

As noted above, the Administration's economic strategy from the beginning has been relatively straight-forward: first stabilize the economy and then restructure. It was assumed that growth would return with stabilization. There are several implicit assumptions here: (1) Pakistan's tricky economic situation could not be addressed unless the donor community helped reduce the burden of debt the country carried; (2) to get the donors to help Pakistan, the country had to first successfully complete an IMF stabilization program; and (3) once the burden of debt had become lighter, Pakistan would have the resources needed to jump-start the economy.

The strategy is predicated on creating an environment that will attract high inflows of private foreign investment. Without these foreign funds to supplement low domestic rates of savings, the country will not be able to return to respectable rates of economic growth.

If the structural realities behind the simulations of the 1990s are still indicative (Figure 1), once growth is reestablished there would likely be adequate funds to combat terrorism on two fronts: (1) poverty reduction and improved governance; and (2) increased allocations to security and force modernization. With improved growth and modernization of institutions, the attractiveness of terrorism would diminish. In turn this would create an environment more conducive for further inflows of capital. In this sense, the IMF programs and the war on terrorism would complement each other.

With these considerations in mind, the main successes to date include:

- A significant improvement in the external accounts. Current account deficits of the 1990s have now been turned to surpluses, currently at around 2.8% of GDP.
- Foreign exchange reserves have risen to $5 billion, sufficient to finance 6 months of imports.
- The exchange rate has stabilized.
- Workers remittances for 2002 will be around $2 billion, doubling from 2001.
- Inflation is around 3%, lowest in three decades.
- The interest rate is declining.
- The stock market is booming with the index up 40% over 2001.
- The rising trend in both domestic and external debt has been arrested. In fact the former, declined substantially over 2001, down from 52% of GDP to 46%. External debt and other foreign exchange obligations remained at 38 billion, with no increase since 1999.
- Tax collection grew by 13% per annum, but the current year's growth will be lower due to the economic disruption stemming from 9/11.

While the indices cited above paint an encouraging picture, the economic performance aggregates that really count—GDP and its main components tell quite a different story:

- The average GDP growth of 3.3% per annum in the Musharraf years is the lowest in 12 years. Admittedly declining rapidly in the late 1990s it was still on average 4.6% during the 1990s, with 7.7% in 1991-92 and 6.5% in 1995-96.
- Overall investment as a percentage of GDP has been declining steadily from 20% in 1991-92 to 17.3% in 1997-98; it went down below 14% in 2001-02. This is the most serious manifestation of an economic slowdown because it will affect not only the pace of economic growth in the coming years, but also many other key sectors like employment and exports.
- Both the public and private sectors share this decline in investment; but public sector has declined more rapidly in the past 10 years—from 9.1% to 4.7% of GDP—while private investment has gone down from, 10.1% to 7.6% of GDP. In the public sector, development expenditures have declined from 6.7% of GDP to 2.8% of GDP.
- Exports have continued to stagnate and will probably be lower than $8.9 billion in 2000-01 against a target of $10 billion.
- The rate of unemployment has also gone up from about 5% in the early 1990s to 7.8% in 2001-02.
- A major indicator of macroeconomic stability, the fiscal deficit, having improved to 5.3% of GDP in 2000-01 again deteriorated to 7% of GDP in 2001-02.
- According to the Asian Development Bank (2002) the incidence of poverty increased from 26.6% in FY 1993 to 32.2% in 1999. The report goes on to conclude that development spending has continued to decline and that it is highly likely that the incidence of poverty in Pakistan today is significantly higher than in FY 1999.

Critics of the Musharraf reforms (Bano 2002) also stress the fact that their whole orientation is inappropriate: in addition to the growing level of poverty noted above, 60% of the population has no access to education. 50% has no access to basic health services, while the same number does not have access to sanitation facilities. At the same time the country has one of the highest population growth rates at 2.8%. Growing unemployment of the youth has led to increased frustration, but more importantly has created an environment where radical Islamists have been able to capitalize, as evidenced by their striking gains in the last election.

In sum, while many macroeconomic indicators targeted by the IMF show encouraging improvement, the indicators that really count in terms of standards of living—investment, GDP growth, health and education and so on have not shown much of an advance, and in some cases have even deteriorated. This has lead some observers (Vreeland 2002) to believe that the reforms are fundamentally flawed due to the inability of the IMF and Pakistan to learn from past mistakes—most notably, redistributing income toward elites while failing to promote economic growth and attack poverty.

The Fund seems to have recognized this flaw and is attempting to divert more spending toward social programs by requesting the government begin cutting defense expenditures (Malik 2002). If these cuts extend to intelligence and the security forces and if anti-terrorism is a goal of the Fund, then it is clear that it considers poverty reduction a much more potent tool than expanded security expenditures. In any case, one must conclude that the IMF program and the war on terrorism are conflicting objectives, at least in the short-run.

Future Prospects

While foreign assistance through the international agencies has increased, the foreign investment that Pakistan seeks has not been forthcoming, except to a limited extent in the oil and gas sectors. The portfolio investment which was large in the mid-1990s has virtually dried up and there has in fact been a rapid outflow of that investment. Clearly, pending the return of foreign investors, the post 9/11 influx of aid/assistance and debt relief has been a great stop-gap help in implementing the strategy. Aid, however cannot be a permanent solution to the country's many economic problems.

Although appearing sound on the surface, there are several problems with this strategy in the context of the question addressed here: (1) Implicit in this strategy is the notion that it is focused on the long term revival of the economy—i.e., it may be some time before the average man on the street sees a material improvement in his welfare; (2) the mix of economic policies is not based on a political consensus—while the government has tried to inform the people of its new policies, it has not sought any national consensus on them and it has tended to ignore the pains caused to the people by the increase in taxes or spreading of the existing taxes or the stiff increase in the utility rates in a poor country; and (3) the strategy is high risk.

The strategy is high risk largely because its success depends on traversing a fairly narrow critical path with little room for error; and favorable developments of a number of factors, many of which are outside the control of the authorities. Even if these favorable developments come to pass, foreign investors may not return in large numbers because domestic terrorism is likely to remain a problem for the foreseeable future. Investors are also concerned that another conflict with India could break out at any time. Because the strategy is high risk, its chance of success is problematical.

In any case, if growth does not materialize soon, problems (1) and (2) above will reinforce each other so that even a rubber stamp Parliament is likely to modify the current set of economic policies to be more populist oriented. There will be less incentive to complete IMF programs and the investment climate will deteriorate. At that point the outcome is unclear—the return of the military? An anti-American, anti-IMF Islamic take-over?

For more topical analysis from the CCC, see our Strategic Insights section.

For related links, see our South Asia Resources and our Homeland Security & Terrorism Resources.

For Further Reading

"President Hopes Government Will Benefit from his Policies" (*Dawn*, November 17, 2002)

"Asian Development Bank, Poverty in Pakistan - Issues Causes and Institutional Responses" (*Manilla: ADB*, 2002)

Masooda Bano, "What Reforms?" (*The News*, November 15, 2002)

Jennifer Bremer and John Kasarda, "The Origins of Terror: Implications for U.S. Foreign Policy" *The Milken Instiutute Review* (Fourth Quarter 2002)

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Robert Looney "Pakistani Defense Expenditures and the Macroeconomy: Alternative Strategies to the Year 2000" *Contemporary South Asia* (1995, vol 4, no. 3)

Nadeem Malik, "IMF Asks Pakistan to Cut Defense Spending" (*The News*, November 8, 2002)

James Raymond Vreeland, "Pakistan's Debt of Gratitude" (*Foreign Policy*, March/April 2002)